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Ober|Kaler Real Estate Update

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Let the Banker Beware – Top Ten Issues for Selling REO

As the philosopher Yogi Berra famously said, “Its déjà vu all over again.” Or so it is for those of us who lived thru the last great real estate downturn in the late 1980s and early 1990s.

As the current real estate cycle continues its downward spiral, banks are once again reluctantly becoming owners of real estate. Most banks want to sell their REO as promptly as possible. In so doing, however, they become sellers of real estate, rather than lenders on real estate. This means that the underlying legal documentation moves from loan documents (with which banks are familiar) to contracts of sale (with which they are probably less familiar). While real estate contracts often appear simple and straight forward, there are a number of more subtle issues that banks need to be aware of when they enter into contracts to sell their REO. With apologies to David Letterman, here is a list of what I consider the top ten REO seller issues.

1. Who is your buyer?

Most contracts require the buyer to provide certain indemnities (e.g., against injuries sustained if the buyer or its agents enter the property during a study period or against a claim for a commission by the buyer’s broker). They also provide for attorneys’ fees for the prevailing party in the event a

dispute under the contract ends up in litigation. Many buying entities, however, are single purpose entities with virtually no assets beyond a deposit delivered when the contract is executed. In that case, the seller/bank may not receive the benefit of these provisions, and, in the worst case scenario, could face the prospect of paying attorneys' fees to the buyer in connection with losing a suit arising out of the contract, but not having the ability to collect attorneys' fees from the buyer if the seller/bank prevails in the suit. Even if the seller/bank holds the real estate in a single purpose entity, that entity has substantial assets, consisting of the equity in the real estate. Seller/banks should determine whether the buyer has assets and should consider adjustments to the contract in the event the buyer does not.

2. Representations and Warranties made "to the best of the Seller's knowledge."

Naturally, seller/banks want to limit to the greatest extent possible representations or warranties they make regarding their REO. Some buyers, however, especially if they are paying close to a market price (surely, that must occur on occasion) will insist that they receive protections afforded by certain representations or warranties. Frequently, seller/banks will try to limit their exposure by qualifying representations or warranties "to the best of the Seller's knowledge." It is far from clear, however, exactly what that phrase means. For instance, if the workout group does not know of an issue with the property, but the originating loan officer does, is the seller/bank charged with that knowledge? Also, if the workout officer has no knowledge, but if there is a document somewhere in the bank's expansive files that relates to the matter, is the bank charged with knowledge of the contents of that document? In order to avoid these issues, it is best if the contract contains a definition of knowledge. For example: "as used herein, 'to the best of the Seller's knowledge' means to the actual knowledge of ___ (insert name of bank officer negotiating the contract) ____, excluding constructive knowledge and imputed knowledge and any duty to make any investigation."

3. Reissuing Representations and Warranties at Closing.

Another issued posed by representations or warranties is the typical requirement that the seller/bank's representations and warranties are reissued on and as of the date of closing. It is one thing for a seller/bank to represent that it has no knowledge of a specific fact on the date a contract is signed, but it is quite another to agree, when signing the contract, that the seller/bank shall reaffirm and reissue its representations and warranties on the closing date. The seller/bank must make an adjustment to provide for the possibility that something will occur or that the seller/bank will obtain knowledge after the date the contract is signed but before closing, such that one of the representations or warranties given at the time the contract is signed is no longer true. There are several ways of dealing with this issue.

4. Survival of Representations and Warranties.

Yet another issue relating to representations and warranties is how long they survive closing. Obviously, the seller/bank would prefer that representations and warranties terminate on the closing date, while the buyer would prefer that they survive indefinitely. Typically, the parties reach an agreement that the representations and warranties will survive for a specific period of time, on the order of months or years. Yet, this alone does not provide certainty. For instance, if the contract provides that representations and warranties survive closing for six months, does that mean that the buyer, two years after closing, can bring an action for breach of a representation or warranty if it had notifies the seller/bank within six months after closing that the representation or warranty was breached? In order to avoid such uncertainty, it is recommended that the survival provision include language such as "the representations and warranties made by the Seller shall survive Closing for six months and no longer and the Buyer shall be barred from bringing any action based upon an alleged breach of a representation or warranty, unless the Buyer has filed a complaint against the Seller in a court of competent jurisdiction, within six months from the date of Closing."

5. Closing Deliveries.

Most contracts will provide that, at closing, the seller/bank will need to deliver certain customary items, including items required by the title company. The seller/bank's obligation under this paragraph must be limited; otherwise a carefully drafted title provision in the contract can be overridden by a comprehensive and unreasonable owners affidavit required by a title company. There is almost no limit to what some title companies will ask a seller/bank to represent or warrant in such an affidavit. To eliminate this risk, the contract should provide that the seller/bank will deliver, at closing, a title affidavit and a gap indemnity in the form which is attached to the contract as an exhibit. Also, along these lines, any further assurances provision in the contract must be carefully considered.

6. Delivery of Study Materials.

Most buyers ask seller/banks to deliver certain study materials for the buyer's review during a due diligence period. There are a number of issues presented by this provision. First, some contracts provide that the study period does not begin to run until the day the buyer receives the study materials. Obviously, this provision is not acceptable. Additionally, the seller/bank may want to qualify this requirement by limiting the materials provided, by stating that the buyer relies on any such materials at its sole risk and by limiting the seller/bank's obligation to a "good faith effort" to deliver these materials. That way, the seller/bank will not have committed a default if at some point

(after the time for delivery has passed) additional relevant materials are discovered in the bank's files. Also, as a matter of convenience, the seller/bank may want to require the buyer to come to the bank's office to review the materials, rather than agree to deliver them to the buyer.

7. Title.

The title provision is one of the trickiest in the contract. Buyer's will often want the seller/bank to convey good and merchantable title and may also want the right to obtain a title commitment and then deliver a letter specifying various matters affecting title that the buyer finds objectionable. The seller/bank should not agree to cure any title defect. Nor, if they can avoid it, should the seller/bank agree to let the buyer raise issues in a title objection letter (letters like that sometimes contain a huge number of often ambiguous issues). It is best to agree only to provide "fee simple title" subject to all matters of public record or that would be disclosed by an accurate survey as of the date of the contract. The seller/bank may also want to limit the buyer's remedy in the event that title is not good or otherwise does not satisfy the requirements of the contract.

8. Buyer's Remedies in the Event of Default.

In the buyer's ideal world, if the seller/bank defaults, the buyer would be entitled to exercise all remedies provided at law or in equity, including specific performance. Seller/banks would prefer to limit the buyer's remedies to the return of the deposit, but many buyers will not agree to such a limitation. One alternative that may be acceptable to the buyer is to limit the buyer's remedies to the return of the deposit, but also agree to reimburse the buyer for out-of-pocket expenses paid to unrelated third parties up to a specific dollar figure cap. Ideally, the seller/bank should also exclude specific performance, although many buyers will insist upon having that remedy available. The availability of specific performance, however, allows the buyer to tie up the property in the event of a dispute (since a title company will not insure title if a specific performance claim is pending, no matter how far fetched the claim may be). Moreover, specific performance can take the form of requiring the bank to specifically perform all of the covenants in the contract, not simply the obligation to convey the real estate. If the buyer demands specific performance as one of its remedies, the seller/bank could try and limit the availability of specific performance to certain breaches, provide $_{\text{that}}$ monetary damages are not available and possibly require an election to bring an action for specific performance within a short period of time after the scheduled closing. In any event, the seller/bank should expressly exclude lost profits, special damages or other consequential damages.

9. Time of Essence.

Seller/banks typically require and most buyers will agree that the time is of the essence of the contract. The seller/bank should, however, keep in mind that courts do not look favorably upon time is of the essence provisions. One consequence of this is that if the date for closing under a contract (containing a time is of the essence clause) is extended, some courts will take the position that time is no longer of the essence of the contract. Accordingly, in any amendment extending the time for closing under a contract, the amendment should expressly provide that time remains of the essence.

10. No Binding Agreement unless Contract is Fully Executed and Delivered.

Unfortunately, the possibility does exist that an aggressive potential buyer may want to tie up title to a property even if a negotiation between the buyer and the seller/bank does not result in an executed contract. While one would think that the buyer could not do this, based upon a contract that the seller/bank did not execute and deliver, buyers do occasionally bring (or threaten to bring) suits for specific performance in such circumstances. (Remember, the buyer may have no real assets and at this point would not even have posted a deposit). In such a case, the buyer may claim that all terms and conditions of the contract had been agreed upon and the formality of execution was satisfied by language in an e-mail or some other act. In order to protect against this type of claim, the seller/bank may want to include language in the contract such as:

> Submission of this Contract by the Seller shall not constitute the making of an offer to sell the Property and shall not constitute a reservation of the property for sale to the Buyer. This Contract shall not be binding against either the Seller or the Buyer nor shall either the Seller or the Buyer have any liability or obligation against or to the other, in connection with the transaction that is the subject of this Contract, until fully executed copies of this Contract are delivered to each of the Seller and the Buyer.

Additionally, the seller/bank or its counsel should make it clear, when the first contract drafts are circulated, that the seller/bank will have no obligation until full execution and delivery of a formal contract.

These are just a few of many issues that may circulate beneath the surface in what is an apparently “simple” contract for the sale of REO. Bank officers should be very careful when negotiating such contracts, lest a property, which already was associated with a loss for the bank on the loan side, once again becomes a loss for the bank, on the REO side.

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